

(4) *Determination of a partner's interest in partnership capital or income.* For purposes of this paragraph (e), a partner's interest in partnership capital or income is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. See the factors listed in § 1.704-1(b)(3)(ii).

(5) *Special rules on allocation of adjusted basis to partners.* An allocation or reallocation of the adjusted basis of oil or gas property is pursuant to this paragraph (e) of this section deemed to be in accordance with the partner's proportionate interest in partnership capital or income for purposes of this paragraph (e) where so provided in § 1.704-1(b)(4)(v). In addition, in connection with a revaluation described in § 1.704-1(b)(2)(iv)(f), the basis of an oil or gas property is allocated among the partners based on the principles used under § 1.704-1(b)(4)(i) of allocating tax items to take into account variations between the adjusted basis of the property and its fair market value. In the case of an oil or gas property contributed to a partnership by a partner, section 704(c) is taken into account in determining the partner's share of the adjusted basis.

(6) *Miscellaneous rules*—(i) Each partner must separately keep records of his or her share of the adjusted basis in each domestic oil or gas property of the partnership, adjust his or her share of such basis pursuant to section 1016 (including adjustments for any depletion allowed or allowable with respect to such property), and use that adjusted basis each year in the computation of his or her cost depletion or in the computation of his or her gain or loss on the disposition (including abandonment) of the property by the partnership.

(ii) The adjusted basis of a partner's interest in a partnership is decreased (but not below zero) pursuant to section 705(a)(3) by the amount of the depletion deduction allowed or allowable to the partner with respect to a domestic oil or gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the partner under section 613A(c)(7)(D), as adjusted by the partner after the initial

allocation. Section 705(a)(1)(C) does not apply to depletion deductions that are not included in a partner's distributive share under section 702. Accordingly, the adjusted basis of a partner's interest in a partnership is not increased under section 705(a)(1)(C) with respect to depletion of oil or gas properties. See § 1.705-1(a)(2)(iii).

(iii) Upon the disposition of an oil or gas property by the partnership, each partner must subtract the partner's adjusted basis in the property from his or her allocable portion of the amount realized from the sale of the property to determine gain or loss. The partner's allocable portion of amount realized must, except to the extent governed by section 704(c) (or related principles under § 1.704-1(b)(4)(i)), be determined in accordance with § 1.704-1(b)(4)(v). Except as otherwise provided (e.g., section 751), the sale of a partnership interest is not treated as a sale of an oil and gas property.

(iv) In the case of a transfer of an interest in a partnership, the transferor partner's adjusted basis in each partnership oil or gas property carries over to the transferee partner. If an election under section 754 (relating to optional adjustment to the basis of partnership property) is in effect, such basis is adjusted in accordance with section 743.

(v) For purposes of section 732 (relating to basis of distributed property other than money) and section 734(b) (relating to optional adjustment to basis of partnership property), the partnership's adjusted basis in oil and gas property is an amount equal to the aggregate of its partners' adjusted bases in the property as determined under the rules provided in paragraph (e)(3) of this section.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, B, and C have equal interests in capital in Partnership ABC. On January 1, 1992, the partnership acquired a producing domestic oil property. The partnership's basis in the property was \$90x. The partnership allocated the adjusted basis of the property to each partner in proportion to the

partner's interest in partnership capital. Accordingly, each partner was allocated an adjusted basis of \$30x. Each partner must separately compute his or her depletion allowance. The amount of percentage depletion allowable for each partner for 1992 was \$10x. On January 1, 1993, each partner's adjusted basis in the property was \$20x (\$30x minus \$10x). On January 1, 1993, the oil property was sold for \$150x. Each partner's gain was \$30x (\$50x allocable share of amount realized minus the partner's adjusted basis of \$20x). Each partner must adjust the partner's adjusted basis in his or her partnership interest to reflect the gain.

Example 2. The facts are the same as in *Example 1* except that on January 1, 1993, the property was not sold but transferred by the partnership to partner A. A's basis in the property was \$60x (the sum of A's, B's, and C's adjusted bases in the property).

Example 3. The facts are the same as in *Example 1* with the exception that in 1992 C was a retailer of oil and gas and was only entitled to a cost depletion deduction of \$5x. C's gain from the sale of the mineral property on January 1, 1993, was \$25x (\$50x allocable share of amount realized minus C's adjusted basis of \$25x (\$30x minus \$5x)).

Example 4. D, a calendar year taxpayer, is a partner in Partnership DEF which owns a domestic producing oil property. On January 1, 1993, the partnership's adjusted basis in the property was \$900x. On January 1, 1993, D's adjusted basis in D's partnership interest was \$300x and D's adjusted basis in the partnership's oil property was \$300x. D's allowable percentage depletion for 1993 with respect to production from the oil property was \$50x. On January 1, 1994, D's adjusted basis in D's partnership interest was \$250x and D's adjusted basis in the partnership's oil property was \$250x (\$300x minus \$50x).

Example 5. On January 1, 1990, G has an adjusted basis of \$5x in partnership GH's proven domestic oil property, which is the sole asset of the partnership. On January 1, 1990 G sells G's partnership interest to I for \$100x when the election under section 754 is in effect. I has a special basis adjustment for the oil property of \$95x (the difference between I's basis, \$100x, and I's share of the basis of the partnership property, \$5x). I is not entitled to percentage depletion with respect to I's distributive share of the oil property income because I is a transferee of an interest in a proven oil property. However, I is entitled to cost depletion and for this purpose I's interest in the oil property has an adjusted basis to I of \$100x (\$5x, plus I's special basis adjustment of \$95x).

Example 6. On January 1, 1960, Partnership JK acquired a domestic producing oil property. On January 1, 1990, the partnership's adjusted basis in the property was zero. On January 1, 1990, L is admitted as a partner to the partnership. Since the partnership's ad-

justed basis in the the oil property is zero, L's proportionate share of the basis in the property is also zero. L is not entitled to percentage depletion because L is a transferee of a proven oil property (see paragraph (g) of this section). Since the property's basis is zero, L is also not entitled to any cost depletion with respect to production from the property.

Example 7. (i) O and P have equal interests in capital in Partnership OP. On January 1, 1991, the partnership acquired an unproven domestic oil property X the basis of which is \$200x to the partnership. The partnership allocates \$100x of the basis of the property to each partner in accordance with each partner's proportionate interest in partnership capital. For the 1991 taxable year, O has a \$10x cost depletion allowance and P has a \$25x percentage depletion allowance. Accordingly, at the end of the 1991 taxable year, O's adjusted basis in the property is \$90x, and P's adjusted basis in the property is \$75x. On January 1, 1992, Q is admitted as an equal partner. The partnership does not use written data from the partners and must therefore assume that each partner was entitled to \$25x depletion based on the assumptions provided in § 1.613A-3(e)(3)(iii). This would result in a \$50x combined depletion allowance for the partners and an aggregate adjusted basis in the oil property of \$150x. Accordingly, the partnership allocates \$50x of the basis of the property to Q, one-third of the aggregate adjusted basis determined by the partnership. O and P must each reduce their basis in the property by one-third. Accordingly, after the admission of Q, O's adjusted basis in the property is \$60x (\$90x minus \$30x), and P's adjusted basis in the property is \$50x (\$75x minus \$25x).

(ii) Assume the same facts as in paragraph (i) of this *Example 7* except that O informs the partnership that its adjusted basis in the property is \$90x (determined without regard to section 613A(d)(1)). The partnership uses the written data provided by O and determines the aggregate adjusted basis in the property to be \$165x (\$90x+\$75x). Accordingly, the partnership allocates \$55x ($\frac{1}{3}$ of \$165x) of the basis of the property to Q, and O and P must each reduce their adjusted basis in the property by one-third, as in paragraph (i) of this *Example 7*. Thus, after the admission of Q, O's adjusted basis in the property is \$60x and P's adjusted basis in the property is \$50x.

(f) *S corporations.* For purposes of section 613A(c)(13), adjustments to shareholders' adjusted bases in any domestic oil or gas property to reflect capital expenditures by S corporations, the addition of a new shareholder or an increase in a shareholder's interest by

reason of a contribution to the S corporation, the redemption of a shareholder's interest, or other appropriate transaction shall be made in accordance with principles similar to the principles under § 1.613A-3(e) applicable to the entry or withdrawal of a partner.

(g) *Trusts and estates.* (1) In the case of production from domestic oil and gas properties held by a trust or estate, the depletion allowance under section 611 shall be computed initially by the trust or estate. The determination of whether cost or percentage depletion is applicable shall be made at the trust or estate level, but such determination shall not result in the disallowance of cost depletion to a beneficiary of a trust or estate for whom cost depletion exceeds percentage depletion. The limitations contained in section 613A (c) and (d), other than section 613A(d)(1), shall be applied at the trust or estate level in its computation of percentage depletion pursuant to section 613A and shall also be applied by a beneficiary with respect to any percentage depletion apportioned to the beneficiary by the trust or estate. The limitation of section 613A(d)(1) shall be applied by each taxpayer (*i.e.*, trust, estate or beneficiary) only with respect to its allocable share of percentage depletion under section 611(b) (3) or (4). For purposes of adjustments to the basis of oil or gas properties held by a trust or estate, in the absence of clear and con-

vincing evidence to the contrary, it shall be presumed that no beneficiary is affected by any section 613A (d) limitations or by the rules contained in section 613A(c)(8) and (9) (relating to businesses under common control and members of the same family and to transfers, respectively), as in effect prior to the Revenue Reconciliation Act of 1990, or has any oil or gas production from sources other than the trust or estate.

(2) The provisions of this paragraph may be illustrated by the following examples.

Example 1. A is the income beneficiary of a trust the only asset of which is a domestic producing oil property. The trust instrument requires that an amount which equals 10 percent of the gross income from the property be set aside annually as a reserve for depletion. In 1975 the property had production of 1,095,000 barrels of oil. The trust's gross income from the property in 1975 was \$30,000x. In that year, after setting aside \$3,000x of income for the reserve for depletion, the trustee distributed the remaining income to A which represented 80 percent of the trust's net income. The percentage depletion computed by the trust with respect to the production (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) for 1975 was \$6,600x. The trust's average daily production for 1975 was 3,000 barrels (1,095,000 ÷ 365 days). The trust's allowable depletion pursuant to section 613A(c) with respect to the production was \$4,400x:

$$\left[\$6,600x \text{ depletion} \left(\frac{2,000 \text{ depletable oil quantity}}{3,000 \text{ average daily production}} \right) \right]$$

Pursuant to § 1.611-1(c)(4)(ii), the percentage depletion of \$4,400x was apportioned between the trustee and A so that the trustee received \$3,000x (an amount equal to the amount of income set aside for the reserve for depletion) and A received \$1,400x of the depletion deduction. The \$1,400x depletion received by A is attributable to 80 percent of the trust's depletable oil quantity, *i.e.*, 1,600 barrels per day.

Example 2. B, a retailer of oil and gas, is the income beneficiary of a trust the only asset of which is a domestic producing oil property. In 1975 the trustee distributed one-half of the trust's net income and accumu-

lated the other one-half for the benefit of the remainderman. One-half of the percentage depletion computed by the trust with respect to the production from the property was apportioned to B. Since B is a retailer of oil and gas, B is not entitled to deduct any of the percentage depletion apportioned to B. However, B is entitled to take cost depletion with respect to one-half of the production from the oil property, notwithstanding the fact that depletion was computed at the trust level on the basis of percentage depletion.

(h) *Businesses under common control; members of the same family*—(1) *Component members of a controlled group.* For purposes of only the depletable quantity limitations contained in section 613A (c) and this section, component members of a controlled group of corporations (as defined in paragraph (1) of § 1.613A-7) shall be treated as one taxpayer. Accordingly, the group shares the depletable oil (or natural gas) quantity prescribed for a taxpayer for the taxable year and the secondary production (to which gross income from the property is attributable before January 1, 1984) of a member of the group will reduce the other members' share of the group's depletable quantity.

(2) *Aggregation of business entities under common control.* If 50 percent or more of the beneficial interest in any two or more entities (*i.e.*, corporations, trust, or estates) is owned by the same or related persons (taking into account only each person who owns at least 5 percent of the beneficial interest in an entity and with respect to such person his or her entire interest) as defined in paragraph (m) (2) of § 1.613A-7, the tentative quantity determined under the table in section 613A(c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among all such entities in proportion to their respective production. This paragraph (h)(2) shall not apply to component members of a controlled group of corporations (as defined in § 1.613A-7 (1)). For purposes of determining ownership interest, an interest owned by or for a corporation, partnership, trust, or estate shall be considered as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be.

(3) *Allocation among members of the same family.* In the case of individuals who are members of the same family, the tentative quantity determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among such individuals in proportion to the respective production of barrels of domestic crude oil (and the equivalent in barrels to the cubic feet of nat-

ural gas determined under paragraph (h)(4)(ii) of this section) during the period in question by such individuals.

(4) *Special rules.* For purposes of section 613A (c)(8) and this section—

(i) The family of an individual includes only his spouse and minor children, and

(ii) Each 6,000 cubic feet of domestic natural gas shall be treated as 1 barrel of domestic crude oil.

(5) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. A owns 50 percent of the stock of Corporation M and 50 percent of the stock of Corporation N. Both corporations are calendar year taxpayers. For 1975 Corporation M's production of domestic crude oil was 8,000,000 barrels (365,000 of which was secondary production) and Corporation N's was 2,000,000 barrels (all of which was primary production). The tentative quantity (2,000 barrels per day) determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) must be allocated between the two corporations in proportion to their respective barrels of production of domestic crude oil during the taxable year. Corporation M's allocable share of the tentative quantity is 1,600 barrels:

$$\left[2,000 \left(\frac{8,000,000}{10,000,000} \right) \right]$$

and Corporation N's allocable share is 400 barrels:

$$\left[2,000 \left(\frac{2,000,000}{10,000,000} \right) \right]$$

With respect to M's primary production, M's depletable oil quantity is 600 barrels (1,600 barrels - 1,000 barrels [365,000 secondary production ÷ 365 days]). N's depletable oil quantity, unaffected by M's secondary production, is 400 barrels.

Example 2. Assume the same facts as in *Example 1* except that Corporation M is a retailer and Corporation N is not selling its oil through Corporation M. Because Corporation M is a retailer, no portion of the tentative quantity is allocated to Corporation M. Accordingly, Corporation N's depletable oil quantity is the entire 2,000 barrels per day because section 613A (c), which contains the allocation requirements, is inapplicable to retailers.

Example 3. Corporations O and P are members of a controlled group and are treated as one taxpayer as provided in paragraph (h)(1)

of this section. Corporation O owns oil properties A and B. Property A had primary production for 1975 of 800,000 barrels of oil. Property B had secondary production for 1975 of 365,000 barrels of oil. Corporation P owns oil property C which had primary production of 660,000 barrels for 1975. The allowable percentage depletion with respect to property B's secondary production was \$360x. The controlled group's average daily production was 4,000 barrels $[(800,000 + 660,000) \div 365]$. The controlled group's depletable oil quantity was 1,000 barrels $[2,000 \text{ tentative quantity} - 1,000 \text{ average daily secondary production } (365,000 \div 365)]$. The allowable percentage de-

pletion pursuant to section 613 (a) (computed as if section 613 applied to all of the production at the rate specified in section 613A (c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was \$800x with respect to production from property A and \$660x with respect to production from property C.

Corporation O's allowable depletion pursuant to section 613A (c) with respect to property B's secondary production (for which depletion is allowable before primary production) for 1975 was \$360x. Corporation O's allowable depletion pursuant to section 613A (c) with respect to property A was \$200x:

$$\left[\$800x \text{ depletion} \left(\frac{1,000 \text{ depletable oil quantity}}{4,000 \text{ average daily production}} \right) \right]$$

Therefore, Corporation O's allowable depletion pursuant to section 613A (c) was \$560x (\$360x relating to property B plus \$200x relat-

ing to property A). Corporation P's allowable depletion pursuant to section 613A (c) with respect to property C was \$165x:

$$\left[\$660x \text{ depletion} \left(\frac{1,000 \text{ depletable oil quantity}}{4,000 \text{ average daily production}} \right) \right]$$

(i) *Transfer of oil or gas property*—(1) *General rule*—(i) *In general*. Except as provided in paragraph (i)(2) of this section, in the case of a transfer (as defined in paragraph (n) of § 1.613A-7) of an interest in any proven oil or gas property (as defined in paragraph (p) of § 1.613A-7), paragraph (a)(1) of this section shall not apply to a transferee (as defined in paragraph (o) of § 1.613A-7) with respect to production of crude oil or natural gas attributable to such interest, and such production shall not be taken into account for any computation by the transferee under this section.

(ii) *Examples*. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On January 1, 1975, Individual A transfers proven oil properties to Corporation M in an exchange to which section 351 applies for shares of its stock. Since there is no allocation requirement pursuant to section 613A(c)(8) between A (the transferor) and Corporation M (the transferee), the transfer of the proven properties by A is a

transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990) and percentage depletion is not allowable to Corporation M with respect to such properties.

Example 2. On January 1, 1975, Corporation N sells proven oil property to Corporation O, its wholly-owned subsidiary. Because the transfer was made between corporations which are members of the same controlled group of corporations, Corporation O is entitled to percentage depletion with respect to production from the property so long as the tentative oil quantity is allocated between the two corporations. If Corporation N were a retailer, the tentative oil quantity would not be required to be allocated between the two corporations (see example 2 of § 1.613A-3(h)(5)), and Corporation O would not be entitled to percentage depletion on the production from the property.

Example 3. B, owner of a proven oil property, died on January 1, 1975. Pursuant to the provisions of B's will, B's estate transferred the oil property on April 1, 1975, into a trust. On July 1, 1976, pursuant to a requirement in B's will, the trustee distributed the oil property to C. The transfer of the oil property by the estate to the trust and the later distribution of the property by the trust to C are